BT Pension Review
2nd Consultation

UKCTA Response to Ofcom

Submitted to Ofcom: 15th October 2010

UKCTA is a trade association promoting the interests of competitive fixed-line telecommunications companies competing against BT, as well as each other, in the residential and business markets. Its role is to develop and promote the interests of its members to Ofcom and the Government. Details of membership of UKCTA can be found at www.ukcta.com.

This response is focused upon on Ofcom's second Pension's Review consultation and is concerned with pension funding for BT. The views expressed by UKCTA in this response do not reflect the views of KCOM Group, The Post Office Ltd & Scottish and Southern Energy plc . These UKCTA members may be submitting their own responses to the consultation.

Introduction

UKCTA welcomes this second Ofcom consultation into the policy options around funding BT's pension liabilities and the associated review of the regulatory cost of capital. These issues are of key importance to both UKCTA members and consumers, with pension costs ultimately passed through regulatory charges on to end users.

UKCTA members are supportive of Ofcom's initial conclusion on deficit repair. We do not question the need to contribute to BT's pension costs when we purchase regulated products, however we do not believe that deficit repair costs are part of the relevant cost stack of regulated products. We also welcome the confirmation that the accounting charge will continue to form the basis of pension service costs in the future as we believe the alternative options of using BT's cash contributions or taking a bespoke approach are neither practical nor transparent. On the issue of adjusting the Regulated Cost of Capital, we would ask Ofcom to look again at its provisional conclusion on this issue as there does seem to be considerable evidence available that points towards a reduction through removing the impact of BT's large defined benefit scheme from the calculation.

This response is divided into three distinct areas, aligning with the three principle issues set out within the consultation:

1) **Deficit Recovery**: we provide our view of on Ofcom's provisional conclusions in this area;
2) **On going pension service costs**: we comment on why we support maintaining the status quo;
3) **Cost of Capital adjustment**: The final section of this response will focus on some of the issues highlighted in the current consultation.

1. Deficit Recovery

UKCTA is opposed to the introduction of any allowance for deficit repair within regulated charges. BT's regulated charges should be based on efficient forwarding looking costs and should not be tied to the individual pension arrangements of the company. We therefore welcome Ofcom's initial conclusion to deny BT the opportunity to included Deficit Repair costs within the cost stack for regulated products.

BT has failed to make the case for deficit recovery. UKCTA members, who purchase a large volume of BT's regulated products, have already paid their fair share towards BT pension costs and BT has failed to demonstrate why they should be required to pay again. Ofcom estimate that £3.6BN of the deficit can be attributed to the pension holiday alone, taken together with other factors such as the shortfall in early leaver augmentation the case for BT making good its own deficit is compelling.

Ofcom have carried out a rigorous assessment of the evidence and we support Ofcom's use of the six principles of cost recovery to assess the case for inclusion of deficit repair within regulatory charging on its merits. While regulatory consistency is important, it also needs to be justified by the evidence. In the case of deficit repair no case has been made to deviate from the status quo, with BT's past conduct dictating that they must meet the cost of their own deficit, this is also true of the case for partial deficit repair, as the issues at stake are identical to those of full deficit repair, with no justification for any element of the deficit to be incorporated within regulatory charges.

Ofcom has no duty to finance BT's network or operations. Indeed Ofcom's duty to encourage investment in an unbiased way should be the key consideration. Unlike in other industries, BT's shareholders have been the sole beneficiaries from BT's pension investment strategy and there has been no previous customer benefit from their investment strategy and/or prior payment holidays.

In summary, when setting charges for regulatory services, Ofcom's objective should be to reach an outcome that replicates a competitive market outcome. Such an outcome would not take any notice of the existence of BT's defined benefit scheme, but push prices down towards an efficient & competitive level. BT's submissions have not taken this debate forward and no case exists to permit deficit recover. We would urge Ofcom to confirm its conclusion that the inclusion of a deficit repair surcharge within the cost stack for regulated products should be denied.

2. On going pension service costs

We continue to believe that Ofcom should decouple the detail of BT's actual pension scheme arrangements from the amount contained within the cost stack for regulated products. The details of BT's pension scheme should be irrelevant. Pension costs are an important part of employee remuneration and a recognised cost of providing services, purchasers of regulated services should pay their fair share of these costs, however BT should only be allowed to recover efficiently incurred labour costs, incorporating all pension costs.

If BT chooses to pay its staff above this level then it of course should be free to do so, but any such spending should be financed by BT shareholders and not its competitors.

We support Ofcom's decision to use the Accounting costs as the starting point for the pension cost element of regulated charges. We do not believe it would be appropriate for BT to use one Pension figure for IAS19 within its statutory accounts and Ofcom not to use the same figure in its model for deriving regulated charges. Ofcom should always be in a position to take the figures used in the statutory accounts and audit them back in a transparent way to regulated charges. The alternative approach of using the cash contribution rate would not be as transparent, not would it be impartial, with BT having more opportunity to blur the line between ongoing service costs and deficit repair. Likewise a bespoke rate would be an onerous undertaking and would potentially lack the necessary transparency required.

We would urge Ofcom to think again about the issue of obtaining efficient forward looking costs, and while we welcome a greater focus on efficiency in future charge control work, we believe some efficiency adjustment should be considered when the statutory accounting numbers are used as the input for the pension cost element within regulated charges.

3. Cost of Capital adjustment

Based on the information shared to date, UKCTA believes that Ofcom should progress with a reduction in BT's regulated Cost of Capital. There is considerable evidence pointing towards the direction of the adjustment and we would urge Ofcom to use its discretion to calculate the magnitude of the adjustment required.

It is a mistake to believe that this issue is not material. It will have a considerable impact on consumers and BT's competitors. It would be wrong to continue with the status quo, when it doesn't take account of the impact of pension risk on BT's cost of capital.

UKCTA is supportive of the concept of regulatory consistency; however it is important that Ofcom sticks consistently with the correct outcome, one that is backed up by the evidence. In our view there is no evidence to support continuing with the status quo on Cost of Capital and an adjustment should now be made to keep Ofcom's policy consistent with the facts.

Ofcom's previous exercise to set BT's regulated Cost of Capital ignored the issue of BT's defined benefit pension scheme, tending to take a very cautious stance on each element of the calculation. The net result of this was a cost of capital that was likely to be tilted in BT's favour at each stage (as Ofcom feared that the consequences of setting the regulated Cost of capital at too low a level were considerably worse than any negative effects stemming from overstating the Cost of Capital). The means that Ofcom does have room for manoeuvre on this issue. A modest downward adjustment at this point would correct this historic imbalance.

Ofcom should ensure that regulatory charges are based on efficient forward looking costs. These costs should not contain a cost of capital that was inflated as a result of the existence of a large defined benefit scheme. The evidence available on cost of capital points towards a reduction and Ofcom should now act to impose a reduction in BT's regulated Cost of Capital.

Conclusion

Based on all the evidence presented there is no justification to allow BT to recharge deficit repair payments through regulatory charges and BT should retain responsibility for the deficit. We therefore welcome Ofcom's initial conclusions on this matter.

BT inefficiency remains an issue for purchasers of regulated services, with Ofcom's previous approach to charge controls failing to make appropriate adjustments to remove inefficient costs. We therefore welcome any move to scrutinise the efficiency of BT's operation in future charge controls.

It is clear from all the research carried out to date that BT's regulated cost of capital is overstated as a result of the impact of the defined benefit pension fund. This has resulted in BT over-recovering a significant amount through the sale of regulated products.

Ofcom cannot leave BT's cost of capital unchanged and Ofcom must exercise its judgement over the size of the adjustment required. This is issue is very material to consumers and BT's competitors and we would urge Ofcom to take the time to reach the correct answer.

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